A makeover for the Doshi family

Ramesh Doshi is a 33-year old IT professional from Bangalore. He has a gross income of Rs.8.2 lakh per annum. His wife, Sarita, is a homemaker. They have a 4-year-old daughter & a 1-year-old son. Their annual household expenses are Rs 2.5 lakh. The Doshis currently live in a two-bedroom apartment with a loan outstanding of Rs 8 lakh. Ramesh & Sarita would like to move to a bigger house in the near future. They have an amount of Rs 50,000 in bank FDs, Rs 4.46 lakh in PPF, Rs 7.04 lakh in debt mutual funds and Rs 15 lakh in stocks & equity mutual funds. Ramesh is also likely to receive ESOPs worth Rs 4 lakh within a year. Their current real estate allocation after deducting the loan liability is Rs 6.5 lakh. They have Rs 69,000 in gold and jewellery. They want a comfortable retirement on a par with their current standard of living after meeting their children's education and marriage expenses.

The solution

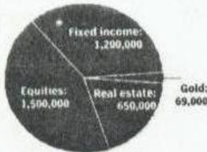
On studying the current asset allocation of the Doshis, we find they are underexposed to asset classes such as real estate and gold.

The current and recommended asset allocations are as follows:

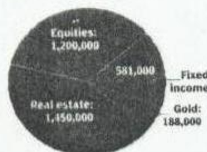
Doshi's employer provides him with ESOPs every 3-4 years. In the past, he has sold the shares received by him through ESOPs and invested directly in equities. This is a good strategy since otherwise he would have been overexposed to a single company for equity investments and also for his salary.

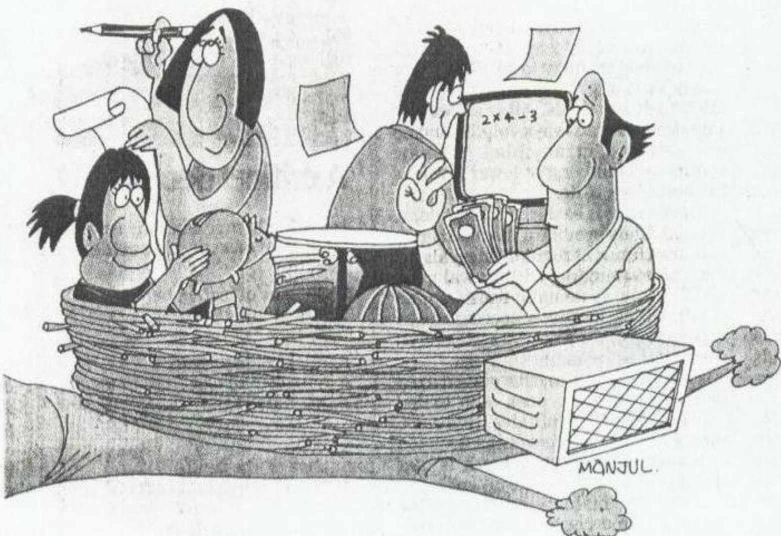
He is expecting to receive ESOPs worth another Rs 4 lakh in the near future. This addition would further make his equity allocation excessive.

Current asset allocation



Recommended asset allocation





Hence, he can draw from his equity portfolio to increase his exposure to real estate. Doshi also has excessive exposure to debt funds, this should be reduced.

In order to achieve the correct balance in his asset allocation, Doshi should do the following: He should transfer an amount of Rs 5 lakh from debt funds and Rs 3 lakh from equities into prepayment of the existing home loan. Thereafter, they can then sell the existing house and use the sale proceeds for down payment of a new larger house. If possible, the loan from the old house should be transferred to the new house in order to save processing charges etc for the new loan.

Loan for the new house can be around Rs 14 lakh for 10 years with an EMI of around Rs 16,000.

It is important that the new house be bought within two years after the sale of the old house, so that sale of old house is exempt from capital gains tax.

Ramesh should also sell debt funds worth Rs 1.19 lakh and invest the same in gold, preferably in the form of non-labour intensive objects such as bricks, coins or bands.

Investments in gold should be made as a contingency reserve up to 5% of their net worth. A recent example was the Asian crisis, which caused severe currency devaluation and made most other investments worthless.

Traditional wisdom has advocated some holding in gold to counter events such as hyperinflation, forced migration, civil wars etc.

This gold will also be useful at the time of children's marriages.

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The other elements of the solution

Insurance

Ramesh Doshi has purchased endowment and money-back policies in the past. The returns from these policies are quite ordinary and have insured him for only Rs 50,000. Hence, it is prudent for him to examine surrendering or making the endowment and money-back policies paid up. He must also buy additional term cover of Rs 10 lakh. This will cost him about Rs 3000 per annum. Additionally, term cover should also be purchased to cover the home loan in case of his unfortunate demise during the tenure of the loan. Medical insurance is provided by his employer for the entire family, which seems to be adequate currently.

Emergency fund

An emergency fund of Rs 85,000 should be maintained in bank fixed deposits in addition to the existing bank FDs. This is required in case of any unforeseen contingency such as a job loss etc. Additional requirements can be drawn from his equity portfolio.

Taxation

The deduction of Rs 1 lakh under section 80C can be claimed from the investments in PPF, insurance premiums and principal component of home loan. Additionally, he can claim a deduction for interest on home loan. In order to save capital gains on sale of his existing house, the new house should be purchased either one year before or within two years after the said sale.

Investment planning

Doshi can generate a surplus of around Rs 2 lakh per annum after catering to expenses such as household expenses, insurance premiums and home loan EMIs. Based on his demographic profile, this should to be invested as follows: Since Ramesh and Sarita both have a PPF account, it is recommended that they invest Rs 30,000 in Sarita's account in addition to the maximum Rs 70,000 in his own PPF account. The rest of the surplus of Rs 1 lakh should be invested in equity index mutual funds through a systematic investment plan (SIP).

Projections

At the retirement age of 60, after catering to his children's education and marriage requirements, Doshi's assets would be about Rs 1.23 crore in PPF, around Rs 6.5 crore in equities, in additional to their investments in gold. This comes to a total wealth of over Rs 8 crore in addition to their house which would be worth about Rs 6 crore. This should be adequate for a comfortable retirement for Doshis on a par with the current standard of living.

The assumptions are as follows: Inflation — 7% pa; equities grow at — 14% pa; PPF earnings — 8% pa; and, real estate grows at — 12% pa.

The solution for this case study has been provided by Veer Sardesai, a Certified Financial Planner, CMD of Sardesai Finance - Financial Planners. He can be reached at feedback@fpsbindia.org